

**REMARKS OF
STEVEN F. GOLDSTONE, CHAIRMAN AND CEO, RJR NABISCO
TO FINANCIAL ANALYSTS
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NEW YORK CITY**

I have today a report to you and our shareholders on the external events affecting our domestic tobacco company and its future. My investors and all of you in this room have expressed concerns about these events, and what they may mean about the future -- and you are right to be concerned. Everybody should be.

For years, our political leaders in Washington have failed to address the real choices the country faces about tobacco, but the choices are clear to me. Outright prohibition is one option. We have tried that before for alcohol and I don't think anyone wants to go back to that. Government takeover of the tobacco industry is another, following the model that exists in many countries today. And private enterprise, the way we have it today, is the third. Of course, that requires us to compete, to advertise and market our products, and to manage the business as effectively as possible in order to fulfill fiduciary duties and provide a reasonable economic return to investors.

Washington needs to be challenged to face up to these choices. They cannot have private enterprise make tobacco products if government wants to extract all the financial returns from the business. One high Treasury official actually said, during the last round of Washington discussions, that the government's demands for more and more money could be met if our company would simply not pay any dividends to its shareholders. Imagine -- Washington's plan is for Wall Street to invest the capital and take the risks, but only the government gets the returns.

If Washington wants a government monopoly, they can take the keys to the factories. But they cannot have it both ways. They want to preserve private enterprise to fill the role of scapegoat for all the controversies, but they also want all our revenues to pay for their new bureaucracies and spending programs. They have to get real. A choice for the country must be faced, and made.

The current political posturing has obscured the choices, not defined them. It is this that must change.

For example, right now the country is focused on one important question that needs a better debate:

- What is the best, most effective way to help teenagers make the right decisions about risky behavior, and to reduce the number of children who use tobacco products?

Anyone who says he has the key to stopping kids from making the wrong decision is selling the country a line. There is no silver bullet.

The politicians in Washington certainly don't have the answers, but they are still quite ready to respond to the question, as only Washington can. Impose massive taxes on the 47 million adults who smoke; create a huge new federal bureaucracy; raise the price of cigarettes on 100% of the

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market to influence the 2% of sales to underage smokers; and by the way, use all this money to fund a myriad of new, unrelated federal programs.

Does anyone really think this would work? ... putting aside the economic damage it would do to millions of American farmers, workers and shareholders?

Remember, just two years ago, before Washington really got its teeth into this, the Administration announced in its FDA rule what Secretary Shalala proclaimed was "the most important public health initiative in a generation ... huge in terms of its impact ... which would reduce the amount of teenage smoking by half over seven years," all without any new taxes or any new price increases. Not one penny.

But now Big Government wants to go in a different direction.

The current proposals would involve: massive taxation; massive new profits for government; massive new spending; massive new bureaucracy; and punitive price increases on adults -- all under the political cover of reducing underage smoking. A half trillion in new taxes. New agencies whose only purpose in life is to advise other new federal boards and agencies. Big Government penalizing the exercise of free choice. Unconstitutional prohibition of free speech among adults. All of this from a Republican Senate.

You know that the process that produced these proposals is broken even better than I do. Some of you actually did get a chance to participate in the recent round of so-called debate in Washington. Some of you tried to inform the discussion with objective facts and analysis. I will remind the rest of you what happened.

David Adelman of Morgan Stanley, took some of his time to talk to the politicians about how their huge tax proposals would actually lead to retail prices up to \$5 or \$6 for a single pack of cigarettes, would threaten the viability of RJR Nabisco and the industry and would cause hardship on thousands of American working families.

And all of the rest of you agreed. But Washington would not listen. They continue to deny the undeniable, while simply ignoring Wall Street's professional analysis.

And Gary Black of Sanford Bernstein pointed out to the Congress the objective evidence undermining the popular notion that severe price increases would, by themselves, be successful in reducing youth smoking. He talked about the studies at Cornell and the University of Maryland published in the last few months, which undermine that myth, and he even did his own research which confirmed the conclusion that price increases will not have anything like the fantasy result suggested by the Administration.

But Washington would not listen. The chance to fund new federal spending programs, or to provide tax breaks for the wealthy -- all camouflaged by the rhetoric of protecting youth -- was too great to pass up.

So Washington has ignored you -- not just me -- in this so-called debate, and this has to be of concern to you as professionals. You analyze an industry that Washington wants to tax -- not one they want to understand.

What have they said in response to your analyses? We can disregard you experts. The Treasury Department has concluded that the companies will survive these price increases, and that youth smoking will go down by 50%.

What is the basis for the Treasury's conclusions, which are directly contrary to your work and your expertise?

No one knows. The report is secret. Every one of you should hear an alarm bell right there. If Washington is going to ignore your work, you ought at least be able to see why.

Each of you should be calling for the immediate public disclosure of this Treasury report. We have tried to see it, without success. Do you think it may even be possible that the Treasury's analysis might have been influenced by the tax-raising agenda of the Administration? Since when does a government financial analysis of the tobacco business and youth smoking rates receive a security classification akin to satellite surveillance of Saddam's Republican Guard?

I will leave that for you to pursue, but keep in mind that at least one Republican Senator already passed the buck on this one, saying that if his Committee's financial assumptions about the industry are wrong, it is not his fault. Why? Because he received "assurances" from the Administration that the assumptions were OK. It's not his problem, it's the Administration's. What, me worry? Not my problem. This from a Republican Senate Committee Chairman proposing to pass \$600 billion in tax increases to feed a big new federal bureaucracy.

In any event, the Administration says no one needs to check the Treasury report, because they have the world's greatest expert on the tobacco industry working for them. Someone who got his expertise working on the LBO of RJR Nabisco ten years ago, when he was employed by a New York investment bank.

Let me ask you. Do you happen to know what projection their expert thought was reasonable then about the future operating income of our business in 1997? I do. I went back to our files and looked.

In his expert opinion, he thought it reasonable to assume that in 1997, our domestic tobacco business would have operating income of \$4.5 billion. That is \$4.5 billion.

Each of you in this room knows what Reynolds' income was last year. It was \$1.4 billion. He was off by more than a factor of three.

When it comes to the politics of tobacco, maybe being wrong by over 300% is good enough for Washington. Good enough for Washington to impose \$600 billion in taxes. But it is not good enough for me and my shareholders. I know it is not good enough for you. And it shouldn't be good enough for the country.

Don't you think we ought at least to be permitted to see the Treasury's current projections for the industry? For all we know, their expert could be operating on the same numbers he used the last time. I say make the Treasury Report public and let us see how it stands up to critical analysis.

I will give you another example of what I mean when I say this is not an open or fair debate. I mentioned Gary Black's work on price as a deterrent to youth smoking. What support does Washington have for their notion that taxing 100% of the market to influence 2% of sales really makes sense?

It turns out that the government's economic analysis essentially goes back to a study conducted by two academic economists in 1996, who used data from a University of Michigan survey funded by the National Institute of Drug Abuse.

Guess what? No one who's not on Washington's approved list apparently has been permitted to see critical elements of the underlying data. It is confidential, says the University. Other economists cannot test the study's conclusions because they are not given access to the data.

Once again, full analysis is not even attempted. Republicans on the Senate Commerce Committee were willing to take whatever assumptions were given to them by the Administration. No questions asked. Congress needs to get this information and make it available so that even if they will not do it, other economists can test the validity of the assumptions underlying the Administration's claims, as Gary has begun to do.

But you get my point. The Washington process is not open or fair -- it is way, way off the rails when it comes to tobacco. We in the business are left with only one alternative. We must speak out --, on an ongoing basis -- to inject real facts, and real accountability, into the debate. The Congress will work its will, and it may choose to do so without any due diligence. But we simply must make sure that the record is clear about the quality and the consequences of their decisions.

I am going to try to do this in my remaining time today on just one of the many important issues surrounding tobacco.

I want to talk about the black market in tobacco products. I want to talk about the consequences for the country and its teenagers if Washington's current proposals for tobacco legislation are enacted.

Each of you who knows this business knows that tobacco is today the world's most smuggled legal product. It comes in small packages, is easy to transport, is relatively cheap to produce but expensive to buy, and is used by millions and millions of people. It is legal to possess in the hands of consumers.

Those of you who have spoken to Congress in the last weeks have all warned them about the black market consequences of their proposals. Martin Feldman told them: "It would be a mistake to ignore" this. David Adelman has predicted their current proposal would: "quickly result in a very significant black market for tobacco products in the U.S." Gary Black wrote that:

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"Black market product would displace higher-priced legitimate product, leading to collapse of the industry." Emmanuel Goldman, of Paine Webber, wrote that it would "defeat the government's efforts to raise taxes and stop teens from smoking."

Others have delivered similar warnings to Congress. The Director of ATF told the House Commerce Committee that in the U.S., organized crime is already deeply into the cigarette smuggling business, and that Russian, Middle Eastern and Asian organized crime groups are also involved. As he put it, "these groups are involved in firearms and narcotics trafficking, alien smuggling, and other illegal activities." The GAO told the same House committee that cigarette smuggling in the U.S. was "re-emerging" as a problem and that "substantial smuggling" between states with different tax structures was already occurring, right now.

Once again, Washington will not listen. They are experts on one law and one law only -- the law of unintended consequences. On the black market, there is not even a secret government study, at least not one that they have cited, answering your warnings to them.

But the law of unintended consequences -- in which the politicians slay one dragon and create an even bigger monster, is upon us. Listen to this politician:

"These companies are wise enough to know that they cannot perpetuate their business by debauching grown people, so they go to their method of teaching the young. This must be stopped."

Sound familiar? No, it is not one of today's sponsors of tobacco legislation, it is from the Congress of 1914, during the debate on alcohol prohibition. The unintended consequences of that decision are familiar to all of us. It took 13 years to correct them.

The black market issue is just as real today for tobacco. I want to take a few minutes to describe what we are talking about.

Consider the following scenario, which actually occurred in Canada from 1989 to 1994. The government, in response to calls from the anti-tobacco lobby, passes tobacco legislation causing retail price increases of over \$2 per pack in the first four or five years.

Organized criminal enterprises immediately invest in a comprehensive, sophisticated infrastructure for illegal distribution. Ships are chartered; tractor-trailers are leased; warehouses are procured in and around the major retail markets.

The product is easily acquired. There are hundreds of tobacco manufacturers in the world today - excluding American tobacco companies. Each truck the smugglers hire can hold 695,000 packs -- 14 million cigarettes. If you can get your hands on this product and sell it without paying the taxes, you can make over a million dollars on one truckload.

For retail distribution, the organizations turn first to the street gangs that already exist here, just like they did in Canada. The gang members who sell marijuana find the cigarette business more profitable and less risky.

The gangs begin by selling it on street corners, subway exits and around schoolyards. Demand is great. Pretty soon, "lookalike" brands are developed by offshore manufacturers. They design their packs to resemble the leading legitimate brands, with the same colors and type-style, only without the health warnings and tax stamps.

The illegal market becomes so efficient and robust that every thief sees a pack of cigarettes as ready cash. Thieves start breaking into the stores just to steal the cigarettes. The stores need armed guards at night to prevent break-ins. Trucks transporting legitimate product do become like Brinks trucks, with armed guards riding shotgun to prevent hijacking.

As reported in the Canadian press, it gets so bad that one town on the black market route found itself at war with smugglers:

"Mayor Ron Martelle," it reported, "has been forced into hiding with around-the-clock police protection after receiving threats from cigarette smuggling cartels ... This is the kind of thing one expects in Northern Ireland, Beirut or a city in some Banana Republic, not a Canadian city less than 100 miles from Parliament Hill."

A Canadian Mountie, quoted in the Vancouver Sun, said:

"Smuggling cigarettes into Canada has become more profitable than smuggling narcotics."

The widespread market for contraband causes public disrespect for the law. The Toronto Globe and Mail quoted the head of the Canadian Mounties customs unit in Montreal:

"Everyone thinks the taxes on cigarettes are too high, so it is not a crime to buy them illegally."

A commissioner of the Royal Mounted Police said: The situation is "out of control." The Ottawa Citizen asked: "How did we get ourselves into this terrible mess?"

Eventually, the Prime Minister of Canada announced that the black market, which had achieved a 30% market share of all tobacco products sold in the country, was threatening "the very fabric of society." The high tax on the products was rolled back and the tobacco black market subsided, but the cash injected into organized crime and its black market infrastructure will have lasting impact in increasing crime, criminality and public acceptance of illegal activity.

That is what a black market is, and that is what it does. It actually happened in Canada.

But Washington's tax raisers will not listen to this. A House Committee heard testimony from a Canadian policeman who told them that:

"The wide availability of less expensive contraband cigarettes negated [the government's] efforts to reduce tobacco consumption, particularly among the youth."

He went on:

"Kids were bringing duffle bags full of contraband cigarettes into schools, and selling them to their friends."

In Canada, youth smoking went up by more than 7% over this period. Talk about the law of unintended consequences.

Just last week, on the front page of the Financial Times, was the story of Sweden's decision to roll back their high excise taxes "to curb smugglers." The finance minister said:

"If we remain passive, I am afraid the smugglers will take over more and more."

I will predict flatly, as you experts have, that if the price-hike legislation currently being discussed in Congress is actually implemented, a significant black market, like the one I just described, will occur in this country too. By the year 2000, it will be a significant issue for our country, potentially destroying any effort to control the availability of tobacco products to kids. We need to make sure the public understands the consequences of the decisions to be made about tobacco in our country. So that in the year 2000 the people remember what we said in 1998, and what Washington did. If Washington creates a raging black market for cheap cigarettes on street corners and in schoolyards, the people will be furious, and they will ask, just as they did in Canada: "How did we get ourselves into this terrible mess?"

When they do, I have no doubt that the politicians in office then will once again point to the industry as the cause of all the problems. But they will be wrong. And we need for the people to remember. That is the accountability -- to American parents and children -- that I am talking about.

If we are successful in stimulating a fair and open debate, I think we can bring reason and common sense back to these issues. Do we want to try prohibition for tobacco products? Do we want the government to take over these companies and run them as it sees fit? Or will we accept private enterprise, operating responsibly in a competitive market place?

I believe that at some point down the road, after a full debate, the country will decide that the best answer is to include private enterprise in a balanced solution that permits the industry to support it and participate in it. Much like the June 20th agreement we signed last year.

But the true debate on this is only just beginning.

Thank you, and I will be glad to take your questions.

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